



FIRST DEVONIAN EXPLORATIONS LTD.

ANNUAL REPORT 1987

First Devonian Explorations Ltd. is a Calgary based Canadian controlled Corporation whose business is the exploration for, and the development and production of petroleum and natural gas reserves. The Corporation is solely involved in Western Canada.

First Devonian has evolved from a non-operating low interest holding entity to one which both operates and maintains a controlling interest in a majority of its programs. Prospects are usually generated by the Corporation and then outside participants are brought in who provide carried interests to First Devonian.

CORPORATE INFORMATION

HEAD OFFICE

Suite 380
622 - 5th Avenue S.W.
Calgary, Alberta
T2P 0M6

LEGAL COUNSEL

MacKimmie Matthews
Calgary, Alberta

AUDITORS

Collins Barrow
Calgary, Alberta

DIRECTORS

(403) 264-4405
R. Gordon Cormie
Steven P. Dobrowolski
Robert G. Jennings
Sydney B. Loftus
Wendy Posluns
Lionel Robins
Gary W. Selby
Barbara Stitt
Irving Teitelbaum

REGISTRAR AND TRANSFER AGENT

Royal Trust Corporation
of Canada
Calgary, Alberta

BANKER

National Bank of Canada
Calgary, Alberta

STOCK EXCHANGES

Alberta Stock
Exchange (FDI)

OFFICERS

Steven P. Dobrowolski
President

Vancouver Stock
Exchange (FDI)

Gary W. Selby
Vice-President

R. Gordon Cormie
Secretary-Treasurer

ABBREVIATIONS USED:

| | | |
|--------------------------------|---|-----------------------|
| Bbl | — | Barrel |
| MBbl | — | Thousand Barrels |
| Mcf | — | Thousand Cubic Feet |
| MMcf | — | Million Cubic Feet |
| m ³ | — | Cubic Metre |
| 10 ³ m ³ | — | Thousand Cubic Metres |
| 10 ⁶ m ³ | — | Million Cubic Metres |

FIVE YEAR CORPORATE PROFILE

| | 1987 | 1986 | 1985 | 1984 | 1983 |
|------------------------------|--------------------|-------------|--------------|------------|------------|
| FINANCIAL | | | | | |
| Gross Revenues | \$1,596,094 | \$1,741,525 | \$ 1,369,889 | \$ 970,762 | \$ 605,889 |
| Operating and Royalties | 646,551 | 754,661 | 562,007 | 347,626 | 249,592 |
| General and Administrative | 266,154 | 278,890 | 183,943 | 195,351 | 192,150 |
| Interest | 227,479 | 171,697 | 108,306 | 101,286 | 58,981 |
| Cash Flow | 455,910 | 536,277 | 515,633 | 326,499 | 105,166 |
| Earnings (Loss) | 88,500 | 255,425* | 122,039 | 74,897 | (34,224) |
| Cash Flow per Share | .06 | .12 | .14 | .10 | .03 |
| Earnings (Loss) Per Share | .01 | .05* | .03 | .02 | (.01) |
| Working Capital (Deficiency) | (273,448) | (230,645) | (1,720,721) | (440,581) | (240,488) |
| Long-Term Debt | 2,424,724 | 2,848,474 | 1,625,000 | 1,225,000 | 750,000 |
| Capital Expenditures | 312,196 | 1,965,930 | 2,717,526 | 1,008,337 | 899,986 |
| Shareholders' Equity | 2,168,897 | 2,080,397 | 3,439,263 | 2,802,193 | 2,630,456 |
| Total Assets | 5,769,615 | 6,840,210 | 8,513,566 | 4,847,065 | 4,105,425 |

RESERVES

| | | | | | |
|----------------------------------|----------------|---------|---------|---------|---------|
| Proved and Probable | | | | | |
| Oil — Bbl | 679,000 | 889,900 | 710,404 | 751,600 | 473,585 |
| — 10 ³ m ³ | 108.0 | 141.5 | 112.9 | 119.6 | 75.3 |
| Gas — MMcf | 3,574 | 4,436 | 3,478 | 1,920 | 1,709 |
| — 10 ³ m ³ | 101 200 | 125 600 | 98 470 | 54 381 | 48 396 |

OPERATIONS

| | | | | | |
|---|-------------|------|------|------|------|
| Daily Oil Production — Bbl | 135 | 139 | 75 | 52 | 28 |
| Daily Oil Production — m ³ | 21.4 | 22.2 | 11.9 | 8.24 | 4.47 |
| Daily Gas Production — Mcf | 335 | 101 | 171 | 161 | 161 |
| Daily Gas Production — 10 ³ m ³ | 9.5 | 2.9 | 4.8 | 4.56 | 4.56 |

LAND HOLDINGS

| | | | | | |
|-----------------------|---------------|--------|-------|-------|-------|
| Canada — Net Acres | 10,478 | 10,518 | 7,113 | 3,986 | 3,368 |
| Canada — Net Hectares | 4 242 | 4 259 | 2 878 | 1 612 | 1 362 |

ASSET VALUE

| | | | | | |
|---------------------|--------------------|-------------|--------------|--------------|-------------|
| 15% Discount Factor | | | | | |
| Proven | 8,092,000 | 8,436,000 | 9,090,000 | 8,246,300 | 6,429,200 |
| Probable | 568,000 | 1,424,000 | 2,408,000 | 1,389,000 | 1,381,800 |
| Land | 125,000 | 136,000 | 213,000 | 371,000 | 427,200 |
| TOTAL | \$8,785,000 | \$9,996,000 | \$11,711,000 | \$10,006,300 | \$8,238,200 |

| | | | | | |
|---------------------|---|---|---|---|---|
| Number of Employees | 5 | 6 | 5 | 5 | 4 |
|---------------------|---|---|---|---|---|

*Before unusual items

REPORT TO SHAREHOLDERS

Fiscal 1987 was a period of consolidation for First Devonian Explorations Ltd. in the aftermath of the oil price fall in 1986. A number of measures were taken to position ourselves to again become a successful junior resource company.

The first step in solving any problem is the recognition of the factors giving rise to it. Obviously utilizing hindsight, we were able to determine that the Company was improperly financed in the event of an abrupt price collapse. The following actions were taken during the past year to correct this situation:

- 1) marginal properties in the U.S.A. and a minor interest in a shut-in gas property in Canada were sold. Effects of this have been to streamline operations and to reduce debt through the payout of a \$400,000 debenture;
- 2) emphasis continued to be placed on maximizing cash flow from existing properties with minimal investment. To that end, gas production commenced from our McBride gas field with minor tie-in costs, while a liquids facility was installed in the Virginia Hills Area at no cost to the Company; and
- 3) discussions were held with other entities to consider a potential financing and/or merger with First Devonian. A decision was ultimately reached to pursue a flow through financing which was completed subsequent to year end.

With the above steps taken, a revitalized First Devonian is now in a position to pursue oil and gas prospects and provide the exposure of a growth oriented company to its shareholders. We already have land holdings on prospects capable of development that have sizable reserve potential and other prospects mapped on which we hope to acquire a position.

With the ability to generate and operate quality drilling prospects combined with a relatively low overhead expense, we are advantageously positioned. Also, with specific expertise in a number of regions, First Devonian will continue to be competitive with the industry in a wide range of areas.

First Devonian's revenue fell by 8 percent to \$1,596,094 mainly due to the fact that the first half of our fiscal year's oil production was at a lower price than the prior year. Expenses fell in all categories except interest costs. Cash flow fell by 15 percent to \$455,910. Assuming that

product prices remain constant, our projected financial position for the upcoming fiscal year would include:

- 1) an increase in revenue due to higher oil and gas sales along with a greater amount of income generated through management and operator's fees;
- 2) similar relative production, royalty and general and administrative expenses as 1987 with reduced interest costs as our total debt declines;
- 3) a relative decrease should occur in our depletion and depreciation charges as our reserve base grows; and
- 4) a net overall increase in cash flow and earnings should result.

Oil production for fiscal 1987 remained somewhat constant declining by 3 percent to 135 barrels per day. No additional oil wells were drilled. Gas production was up by 232 percent to 335 Mcf per day. One multizone gas well was drilled in McBride which has yet to be tied in.

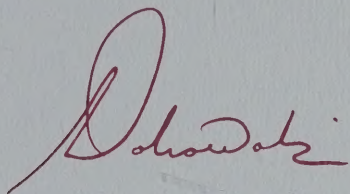
On October 21, 1987, First Devonian closed a \$2,000,000 flow-through issue at \$0.25 per share with funds to be spent prior to February 28, 1989. Flow-through funds are to be used for exploratory and development drilling along with land acquisitions. CEDIP government grants, estimated to exceed \$500,000, will be retained by the Company. Associated tangible expenses are to be funded through cash flow and bank financing. As operator, on behalf of First Devonian and others, we will now embark on a drilling program of approximately \$12,000,000.

Concurrent with the closing of the flow-through financing, a participation agreement was signed with an investor whereby up to \$2,000,000 per annum for a 5 year period may be spent through First Devonian. Advantages to the Company of this participation include certain management fees and an expanded program with the control that higher working interests bring.

First Devonian is in the unique position of being financed for over a year's time and intends to carefully select areas for investment, with a view to having a self sustaining entity at the completion of the program. The past two years have taught us the limitations of any firm belief in financial forecasting; however, with current pricing and based on historic finding costs, we feel that this objective is attainable.

Although dramatic increases in reserves and production, and outstanding financial results are not part of this report, we are pleased at our overall improvement in corporate health. Over time, this deliberate performance should accelerate. We wish to voice our appreciation to staff and investors who have contributed to this improved position.

Submitted on behalf of the Board of Directors.

A handwritten signature in dark ink, appearing to read "Dobrowolski", with a large, stylized initial "D".

Steven P. Dobrowolski
President

November 6, 1987

EXPLORATION AND DEVELOPMENT

First Devonian's 1987 fiscal year had minimal drilling activity. Only one multizone gas well was drilled in Canada which consolidated our position in the McBride gas field. Of more interest to shareholders would be our plans for the upcoming winter drilling season upon which we will elaborate.

DRILLING RESULTS

| | For the Fiscal Year Ending In | | | | |
|----------|-------------------------------|------|------|------|------|
| | 1987 | 1986 | 1985 | 1984 | 1983 |
| Canada: | | | | | |
| Oil | 0 | 7 | 10 | 4 | 6 |
| Gas | 1 | 1 | 4 | 0 | 0 |
| Dry | 0 | 2 | 3 | 0 | 1 |
| Injector | 0 | 0 | 1 | 0 | 0 |
| Total | 1 | 10 | 18 | 4 | 7 |

MAJOR PROPERTIES

The Company's objective will continue to be to develop existing low-risk properties in Western Canada so as to immediately enhance cash flow and we expect to maintain this goal in any acquisition of new lands.

McBRIDE, ALBERTA

A separate seismic anomaly offsetting our McBride gas field is scheduled to be drilled this year in an attempt to increase reserves and deliverability in the area. The existing field is productive from four separate formations and one of our three wells is now producing.

First Devonian holds an interest in 4,320 gross (1,188 net) acres in the McBride Area. The Company also holds an option on an additional section in the nearby Stanmore Area which we may elect to drill and earn if an upcoming seismic program indicates that it is warranted.

VIRGINIA HILLS, ALBERTA

A liquids recovery facility was installed at no cost to First Devonian at our Virginia Hill battery over the past summer months. After initial start-up problems, the facility is now producing 45 barrels of liquids per day. The Company has a production sharing agreement covering this incremental liquids production with the investors that put up the facility costs. We may also pipeline in the

existing gas production of 275 Mcf per day to which we have retained full rights. The gas is currently being flared after the liquids are stripped out. Oil production averaged 288 gross (66 net) barrels per day in Virginia Hills during fiscal 1987.

Our program calls for drilling an additional well in Virginia Hills and implementing a waterflood project. This would bring the total number of producing Beaverhill Lake oil wells to seven in the area with one injector. An attempt to complete a shallow zone in a suspended well will be undertaken.

The Company operates land holdings of 7,040 gross (1,630 net) acres in Virginia Hills.

SWAN HILLS, ALBERTA

The drilling of at least one location is planned in the Swan Hills Area this winter. We will also be reworking certain wells in the area in an attempt to improve productivity. The results of the drilling and rework program will determine whether additional locations exist on the Company's lands.

First Devonian produced 66 gross (39 net) barrels of oil per day from 6 oil wells in the Swan Hills Area during fiscal 1987. We operate lands totalling 3,520 gross (1,750 net) acres in the area.

JUDY CREEK, ALBERTA

Subsequent to its year end, First Devonian increased its land holdings in the Judy Creek Area to 2,720 gross (964 net) acres. We are attempting to further increase our land position in this area prior to drilling a location. The potential exists in Judy Creek for discovery of a feature similar in nature to our Virginia Hills property. The ultimate reserve and productivity characteristics of this prospect make it one of the most exciting ventures that First Devonian will undertake in the near term. We currently operate two oil wells in this area which produced at a rate of 119 gross (22 net) barrels per day last year.

RESERVES AND PROPERTY VALUES

An evaluation of the Company's reserves effective July 31, 1987 was conducted by in house engineering personnel. The following significant revisions were made:

- 1) reserves were reduced by the sale of a shut-in gas property in Wilson Creek and by the sale of marginal producing assets in the U.S.A.;
- 2) changes were made based on the year's actual production rates and operating expenses with the major revision being the reduction of ultimate forecasted recoverable oil reserves in the

Swan Hills Area; and

- 3) incremental proven reserves were added in the Virginia Hills Area due to the planned implementation of a waterflood scheme.

The following table illustrates First Devonian's estimated net oil and gas reserves and future cash flows after the deduction of royalties, overrides, operating and capital costs, and mineral taxes. Alberta royalty tax credit is included in our forecasts and all cash flows are before corporate taxes.

ESTIMATED RESERVES AND CASH FLOW

| Reserve Category | Reserves | | | | Present Value Of Future Cash Flow (M\$) | | | | |
|------------------|--------------------------------|-------|--------------------------------|-------|---|--------|--------|-------|-------|
| | Gas | | Oil | | | | | | |
| | 10 ⁶ m ³ | MMcf | 10 ³ m ³ | MBbl | 0% | 10% | 12% | 15% | 20% |
| Proven | 83.9 | 2,962 | 99.9 | 628.3 | 19,255 | 10,333 | 9,269 | 8,092 | 6,639 |
| Probable | 17.3 | 611 | 8.1 | 50.7 | 1,843 | 792 | 690 | 568 | 425 |
| Sub-Total | 101.2 | 3,574 | 108.0 | 679.0 | 21,098 | 11,025 | 9,959 | 8,660 | 7,064 |
| Undeveloped Land | | | | | 125 | 125 | 125 | 125 | 125 |
| TOTAL | | | | | 21,223 | 11,150 | 10,084 | 8,785 | 7,189 |

The above represents the estimated potential value of the Corporation's oil and gas properties assuming no risk is attached to the forecasts.

With its recent financing, First Devonian will again begin to develop high quality oil and gas reserves situated principally in Alberta. While most expenditures will be in areas in which we are currently established, we also expect to begin to have limited exposure in new areas with similar characteristics.

First Devonian's net asset value at a 15% discount factor declined slightly from \$6,258,931 in 1986 to \$6,031,618 in fiscal 1987. With renewed drilling activity, we will again re-establish a pattern of growth in the Company's value.

NET ASSET VALUE

| | | |
|--|--------------------|---------------------------|
| Asset Value (15% Discount Factor - 50% of probable reserves) | | \$8,501,000 |
| Plus: Notes and Long Term Receivables | \$ 228,790 | |
| | <u>\$ 228,790</u> | <u>\$ 228,790</u> |
| | | <u>\$8,729,790</u> |
| Less: Long Term Debt | \$2,424,724 | |
| Working Capital Deficiency | <u>273,448</u> | |
| | <u>\$2,698,172</u> | <u>\$2,698,172</u> |
| NET ASSET VALUE: | | <u><u>\$6,031,618</u></u> |

PRODUCTION

Oil production rates reflected the limited drilling activity of the Company. Rates fell by 3 percent to 135 barrels per day as no new oil wells were brought into production. The decline in rates was not severe, reflecting the longer term nature of most wells.

Gas production increased sharply by 232 percent as the first well in the McBride Field was placed on stream. We expect further improvements in this area as additional wells remain to be tied into pipelines and a full year's production was not recorded in 1987.

Overall production rates of oil and gas will begin to rise after our second quarter as results of our flow through program begin to be seen. We are pleased to see some stability in our production and a more balanced position between oil and gas production from a variety of sources.

NET OIL AND GAS PRODUCTION

| | For the Fiscal Year Ending In | | | | |
|-------------------------|-------------------------------|------|------|------|------|
| | 1987 | 1986 | 1985 | 1984 | 1983 |
| Daily Oil Production | | | | | |
| — Barrels | 135 | 139 | 75 | 52 | 28 |
| Daily Gas Production | | | | | |
| — Mcf | 335 | 101 | 171 | 161 | 161 |

AUDITORS' REPORT

To the Shareholders
First Devonian Explorations Ltd.

We have examined the consolidated balance sheet of First Devonian Explorations Ltd. as at July 31, 1987 and the consolidated statements of earnings, retained earnings and changes in financial position for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests and other procedures as we considered necessary in the circumstances.

In our opinion, these consolidated financial statements present fairly the financial position of the company as at July 31, 1987 and the results of its operations and changes in its financial position for the year then ended in accordance with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Calgary, Alberta
October 16, 1987

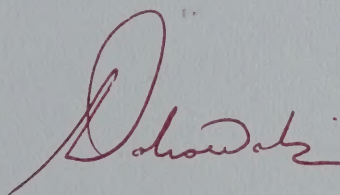
COLLINS BARROW
CHARTERED ACCOUNTANTS

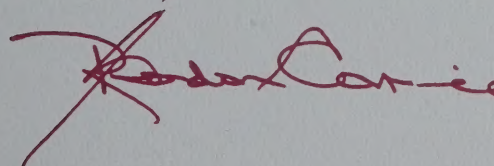
CONSOLIDATED BALANCE SHEET

JULY 31, 1987

| | 1987 | 1986 |
|--|--------------------|--------------------|
| ASSETS | | |
| Current assets | | |
| Accounts receivable | \$ 902,546 | \$1,680,694 |
| Notes receivable (note 2) | 47,800 | 54,050 |
| Long-term receivables (note 3) | 180,990 | — |
| Property and equipment (note 4) | 4,638,279 | 5,105,466 |
| | \$5,769,615 | \$6,840,210 |
| LIABILITIES | | |
| Current liabilities | | |
| Bank overdraft | \$ 76,988 | \$ 25,192 |
| Accounts payable and accrued liabilities | 699,006 | 1,109,897 |
| Current portion of long-term debt (note 5) | 400,000 | 776,250 |
| | 1,175,994 | 1,911,339 |
| Long-term debt (note 5) | 2,424,724 | 2,848,474 |
| SHAREHOLDERS' EQUITY | | |
| Share capital (note 6) | 2,080,397 | 6,730,286 |
| Retained earnings (deficit) | 88,500 | (4,649,889) |
| | 2,168,897 | 2,080,397 |
| | \$5,769,615 | \$6,840,210 |

Approved on behalf of the Board,

 , Director

 , Director

CONSOLIDATED STATEMENT OF EARNINGS

YEAR ENDED JULY 31, 1987

| | 1987 | 1986 |
|---|--------------------|---------------|
| Revenue | | |
| Oil and gas sales | \$1,316,967 | \$ 1,460,655 |
| Alberta royalty tax credit | 172,594 | 108,464 |
| Operator's fees and other | 106,533 | 172,406 |
| | 1,596,094 | 1,741,525 |
| Expenses | | |
| Production | 416,925 | 517,807 |
| Royalties | 229,626 | 236,854 |
| General and administrative | 266,154 | 278,890 |
| Interest on long-term debt | 227,479 | 171,697 |
| | 1,140,184 | 1,205,248 |
| Working capital generated from operations | 455,910 | 536,277 |
| Charges not requiring working capital | | |
| Depletion | 295,000 | 220,600 |
| Depreciation | 72,410 | 60,252 |
| | 367,410 | 280,852 |
| Earnings before unusual items, income taxes and extraordinary item | 88,500 | 255,425 |
| Unusual items | | |
| Write-down of petroleum and natural gas leases and rights in Canada | — | 3,098,700 |
| Write-down of petroleum and natural gas leases and rights in the U.S. | — | 1,811,600 |
| | — | 4,910,300 |
| Earnings (loss) before income taxes and extraordinary item | 88,500 | (4,654,875) |
| Deferred income taxes (recovered) (note 9) | 33,000 | (196,300) |
| Earnings (loss) before extraordinary item | 55,500 | (4,458,575) |
| Extraordinary item | | |
| Income tax reduction resulting from utilization of loss carry-forward | (33,000) | — |
| Net earnings (loss) | \$ 88,500 | \$(4,458,575) |
| Earnings (loss) per share before extraordinary item | \$ 0.01 | \$ (0.96) |
| Earnings (loss) per share after extraordinary item | \$ 0.01 | \$ (0.96) |
| Cash flow per share | \$ 0.06 | \$ 0.12 |

CONSOLIDATED STATEMENT OF RETAINED EARNINGS
YEAR ENDED JULY 31, 1987

| | 1987 | 1986 |
|---|----------------------|----------------------|
| Deficit, beginning of year | \$(4,649,889) | \$ (191,314) |
| Deficit offset against share capital (note 7) | 4,649,889 | — |
| Net earnings (loss) | 88,500 | (4,458,575) |
| Retained earnings (deficit), end of year | \$ 88,500 | \$(4,649,889) |

CONSOLIDATED STATEMENT OF CHANGES IN FINANCIAL POSITION

YEAR ENDED JULY 31, 1987

| | 1987 | 1986 |
|---|-------------|---------------|
| Operating activities | | |
| Earnings (loss) before extraordinary item | \$ 55,500 | \$(4,458,575) |
| Items not involving cash | | |
| Depletion and depreciation | 367,410 | 280,852 |
| Deferred income taxes (recovered) | 33,000 | (196,300) |
| Write-down of oil and gas properties | — | 4,910,300 |
| Cash flow from operations | 455,910 | 536,277 |
| Net change in non-cash working capital balances | (8,993) | (1,298,066) |
| Working capital deficiency acquired on purchase of subsidiary | — | (1,204,654) |
| Cash flow (deficiency) from operations available for investment | 446,917 | (1,966,443) |
| Investing activities | | |
| Acquisition of property and equipment | (442,896) | (1,989,397) |
| Petroleum and other incentive payments | 130,700 | 23,467 |
| Acquisition of subsidiary | — | (210,000) |
| Cash used in investing activities | (312,196) | (2,175,930) |
| Financing activities | | |
| Proceeds (repayment) of long-term debt | (423,750) | 1,223,474 |
| Issuance of share capital | — | 3,303,563 |
| Share capital issuance costs | — | (203,854) |
| Repayment of notes receivable | 6,250 | 11,200 |
| Increase in long-term accounts receivable | (180,990) | — |
| Disposal of property and equipment | 411,973 | — |
| Cash provided (used) by financing activities | (186,517) | 4,334,383 |
| Increase (decrease) in cash | (51,796) | 192,010 |
| Bank overdraft, beginning of year | (25,192) | (217,202) |
| Bank overdraft, end of year | \$ (76,988) | \$ (25,192) |

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

JULY 31, 1987

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The consolidated financial statements of the Company are stated in Canadian dollars and have been prepared in accordance with accounting principles generally accepted in Canada which, in the case of the Company, conform in all material respects with International Accounting Standards. The significant accounting policies are summarized below:

a) Principles of consolidation

The consolidated financial statements include, in addition to the accounts of the Company, the accounts of its wholly-owned subsidiaries, First Devonian Explorations Inc., Barracuda Petroleum Inc., and 497394 Ontario Ltd.

b) Exploration and development costs

The Company follows the full cost method of accounting for exploration and development expenditures, wherein all costs related to the exploration for and the development of oil and gas reserves are initially capitalized. Costs capitalized include land acquisition costs, geological and geophysical expenditures, rentals on undeveloped properties, costs of drilling productive and non-productive wells, together with overhead and interest directly related to exploration and development activities. Proceeds on minor property sales are credited to the net book value of the property and equipment. Gains or losses on major property sales are normally recognized in the statement of earnings.

Exploration and development costs are allocated to two cost centres, namely, Canada and the United States.

Costs capitalized in the cost centres are depleted on the composite unit-of-production method based on estimated proven oil and gas reserves as determined by independent and Company engineers.

In applying the full cost method, the Company performs a ceiling test which restricts the capitalized costs less accumulated depletion and depreciation for each cost centre from exceeding an amount equal to the estimated undiscounted value of future net revenues from proven oil and gas reserves, based on current prices and costs, and after deducting estimated future general and administrative expenses, financing costs and income taxes for each cost centre. In calculating the above cost centre ceiling tests, gas was converted to oil on a 7 MCF to 1 BBL equivalent basis and \$26.00 Canadian per barrel of oil was used as the current price of oil.

c) Depreciation

Lease and well equipment are depreciated on the composite unit-of-production method. Other equipment is depreciated on the declining balance method at 20% per annum.

d) Joint venture accounting

Substantially all of the exploration and production activities of the Company are conducted jointly with others and accordingly these consolidated financial statements reflect only the Company's proportionate interest in such activities.

e) Net earnings (loss) per share

Net earnings (loss) per share has been calculated using the weighted average number of common shares of 8,363,503 outstanding during the year. The conversion of the convertible demand debenture would not be materially dilutive.

f) Cash flow per share

Cash flow per share refers to working capital generated from operations, and it has been calculated using the weighted average number of common shares of 8,363,503 outstanding during the year.

g) Foreign currency translation

The Company follows the temporal method of translation whereby foreign currency accounts and operations are translated to Canadian dollars on the following basis: monetary items at the rate of exchange at the year-end; other assets and liabilities at the historical rate of exchange. The items in the statement of earnings are translated at the average rates of exchange prevailing during the year except for depletion and depreciation, which are translated at the same rates as used for the related assets. Material translation gains and losses on monetary items are included in the statement of earnings.

h) Accounting for changing prices

No procedures have been adopted by the Company to reflect the impact on the financial statements of specific price changes, changes in the general level of prices, or both.

2. NOTES RECEIVABLE

Pursuant to share purchase options exercised, the Company has advanced funds to certain employees to enable them to purchase common shares from treasury. The advances are non-interest bearing, are secured by promissory notes and are due on or before April 10, 1988. It is the opinion of management that repayment terms of the notes receivable will be extended, therefore notes receivable have been classified as long-term assets.

3. LONG-TERM RECEIVABLES

Long-term receivables are due from certain officers and employees, are non-interest bearing and have no fixed terms of repayment.

4. PROPERTY AND EQUIPMENT

Property and equipment consists of the following:

| | Cost | Accumulated Depletion and Depreciation | Net Book Value | |
|--|--------------------|--|--------------------|--------------------|
| | | | 1987 | 1986 |
| Petroleum and natural gas leases and rights including exploration and development thereon | \$7,067,894 | \$3,475,200 | \$3,592,694 | \$4,107,475 |
| Lease and well equipment | 1,814,383 | 798,000 | 1,016,383 | 962,579 |
| Other equipment | 84,979 | 55,777 | 29,202 | 35,412 |
| | <u>\$8,967,256</u> | <u>\$4,328,977</u> | <u>\$4,638,279</u> | <u>\$5,105,466</u> |

During the year, the Company capitalized general and administrative expenses in the amount of \$162,123 (1986 - \$241,079) and interest on long-term debt in the amount of \$40,143 (1986 - \$57,232).

5. LONG-TERM DEBT

Long-term debt is comprised of the following:

| | 1987 | 1986 |
|----------------------------------|--------------------|--------------------|
| Bank production loan | \$1,700,000 | \$2,500,000 |
| Non-convertible demand debenture | 400,000 | 400,000 |
| Convertible demand debenture | <u>724,724</u> | <u>724,724</u> |
| | 2,824,724 | 3,624,724 |
| | <u>400,000</u> | <u>776,250</u> |
| | <u>\$2,424,724</u> | <u>\$2,848,474</u> |

- a) The bank production loan bears interest at one percent over a Canadian chartered bank's prime lending rate and is secured by a \$5,000,000 floating charge debenture over the assets of the Company, a general assignment of book debts, an assignment of accounts receivable, an assignment of shares of the Company's subsidiaries, an assignment of certain monies under a specified contract and by certain oil and gas properties.

The estimated principal payments due on the bank production loan are as follows:

| | |
|--------------------|--------------------|
| 1988 | \$ — |
| 1989 | — |
| 1990 | 460,000 |
| 1991 | 480,000 |
| 1992 | 480,000 |
| Subsequent to 1992 | <u>280,000</u> |
| | <u>\$1,700,000</u> |

- b) The non-convertible demand debenture bears interest at one percent over a Canadian chartered bank's prime lending rate and is secured by certain oil and gas properties. Subsequent to July 31, 1987, the Company retired the non-convertible demand debenture in full with a cash payment of \$400,000.
- c) The convertible demand debenture is convertible, at any time, into 4,706,000 common shares of the Company and is secured by certain oil and gas properties. The debenture is non-interest bearing unless the debenture holder makes demand for repayment, at which time the debenture will bear interest at one percent over a Canadian chartered bank's prime lending rate. At the present time, the debenture has not been demanded for repayment.

The management of the Company does not anticipate that the convertible demand debenture holders will demand principal repayments within the upcoming fiscal year. As a result, the convertible demand debenture has been classified as a long-term liability.

6. SHARE CAPITAL

- a) Authorized

Unlimited number of voting common shares without nominal or par value
4,706,000 Class A voting shares without nominal or par value
1,110,113 First preferred non-voting shares without nominal or par value

- b) Issued

| | 1987 | 1986 |
|---|--------------------|--------------------|
| 8,363,503 Common shares | \$6,205,454 | \$6,205,454 |
| 4,706,000 Class A shares | 471 | 471 |
| 1,096,278 First preferred shares | <u>1,096,278</u> | <u>1,096,278</u> |
| | 7,302,203 | 7,302,203 |
| Less: Deficit offset against share capital (note 7) | (4,649,889) | — |
| Share issuance costs | <u>(571,917)</u> | <u>(571,917)</u> |
| | <u>\$2,080,397</u> | <u>\$6,730,286</u> |

- c) The Class A shares were issued to investors in conjunction with the \$724,724 convertible debenture (note 5). The shares are redeemable from time to time either upon the repayment of all or a portion of the outstanding principal amount of the convertible debenture or upon conversion of the Class A shares into common shares of the Company, on a basis that one Class A share will be redeemed for each portion of the outstanding principal amount of the convertible debenture equal to \$0.154 which is either repaid or converted into common shares.
- d) The first preferred shares bear a 10% non-cumulative dividend accruing, upon declaration, from and after July 31, 1986. The shares are retractable at a retraction value of \$1.00 per share at the option of the holder after 5 years at a rate of 5% of the initial number of such shares held by each holder per year for the next ensuing 10 years and at the rate of 10% of such shares per year for the ensuing 5 years. In addition, the shares are fully redeemable by the Company at a redemption value of \$1.00 per share at the option of the Company at any time.

7. DEFICIT OFFSET AGAINST SHARE CAPITAL

At the annual general meeting on March 11, 1987, a special resolution was passed which authorized a reduction of the Company's share capital by the amount of the deficit as at July 31, 1986 pursuant to Section 36(1) of the Business Corporations Act (Alberta).

8. RELATED PARTY TRANSACTIONS

The Company has a participation plan whereby certain officers and employees are allowed to participate up to a total of 10% of the Company's working interest in new ventures. Participation is on standard industry terms.

9. INCOME TAXES

Income tax expense, comprised exclusively of deferred income taxes, differs from that which would be expected from applying the effective Canadian federal and provincial income tax rates to earnings before income taxes. Details of the changes are set out below:

| | 1987 | 1986 |
|---|-----------|---------------|
| Effective Canadian income tax rate | 47% | 47% |
| Computed "expected" income taxes (recoverable) | \$ 41,595 | \$(2,170,300) |
| Increase (decrease) in income taxes resulting from: | | |
| Tax benefit not recognized on the write-down of petroleum and natural gas leases and rights due to a lack of virtual certainty of realization | — | 2,021,800 |
| Non-deductible crown payments, net of Alberta royalty tax credit | 4,610 | 43,300 |
| Resource allowance and earned depletion | (7,755) | (91,100) |
| Other — U.S. revenue | (5,450) | — |
| Deferred income taxes (recovered) | \$ 33,000 | \$ (196,300) |

10. SUBSEQUENT EVENT

Subsequent to year-end, two agreements were entered into whereby the Company is committed to issue 8,000,000 "flow-through" common shares at \$0.25 per share during the period from October 21, 1987 to February 28, 1989. The funds to be received from the issuance of these shares must be spent on qualifying expenditures as defined in the Income Tax Act. Under the terms of agreements, all government grants earned that relate to these qualifying expenditures are to be retained by the Company, and the Company must renounce \$2,000,000 of tax write-offs, net of any government grants, to the investors during this time period.

11. SEGMENTED INFORMATION

The Company operates exclusively in the oil and gas industry and as such is defined as having a dominant industry segment. During the year, all the property and equipment in the United States cost center was sold or abandoned, leaving the Company with a single cost center, namely Canada.

12. COMPARATIVE FIGURES

Certain comparative figures have been reclassified to conform with current year presentation.

